

State Of the Markets: Macro Commentary

Move from Risk-off To Risk-On

After the market move over the last few days I am moving from positioning for risk-off to risk-on. I know that is easy advice for me to give since most of you are managing risk in these volatile markets, and just trying to survive. However, that is my role of trying to figure out what happens next and is least expected and that is moving to risk-on positioning. As shown in Table 1 below, I believe that the market has finally priced in something between a recession and a recession with a crisis. But my view is that this will end up being short lived crisis, which will reveal the upside of risk assets.

Against that backdrop: here is what I am recommending.

1. Close my long receivers on the 2-yr
 - a. More a directional trade at this stage, but I am keeping my curve steepener
2. Close my long protection on IG
 - a. Again, the upside in a sell-off in a further sell-off in equities has lost is gone. Probably rather be buying IG credit rather than selling it
3. Buy US equity with a 5% stop
 - a. I look at this as a trade with a downside of 5% and an upside of 20% within 6 months.
4. Buy the USD vs Euro/Yen
 - a. Flight to safety reverses

Table 1:

Event	Maximum Sell-off
Recessions	
1980	-15%
1981/82	-21%
1990	-18%
2001	-14%
2008	-16%
Crisis	
1987 Stock Market Crash	-32%
1998 Russia/LTCM	-18%
2001-2 Tech Bubble Burst	-31%
Dec 2018 China Slowdown	-15%
Recessions & Crisis	
2001	-24% with 9/11
2008	-54% with Lehman
Now	
Feb 19, 2020 - March 9, 2020- Coronavirus	-19%

Yes, there is the potential downside of another 5 to 10% if this event turns into both a recession and a crisis, but I am betting that it is more a crisis that ebbs rather than more structural slowdown of a recession. More importantly, the upside is substantially greater than even this downside. First, my view is that the coronavirus will be shown to be closer to a seasonal flu rather than the Spanish flu. Basically, a flu with a high level of infection like a seasonal flu but with a higher case mortality rate, think 1% vs .1%. However, not the Spanish flu with a mortality rate of the 4 or 5% mortality of

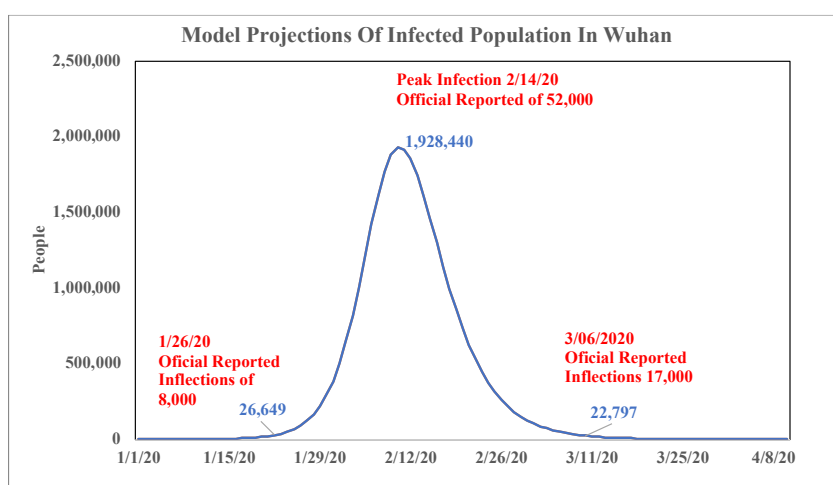
the Spanish flu, which seems to be the markets expected scenario. That realization alone should turn the markets from risk-off to risk-on. Particularly given that the major economies in the world prior to the black swan of the virus will accelerating driven both by the china/us trade accord and the resolution of Brexit. Second, at pretty much the same time data come in to support that view, stimulus of the level of

2008 will already be online overreacting to the markets pricing in the Spanish flu, e.g. Governments spending growth, credit growth, low policy rates and other monetary stimulus.

So, here is the likely negative news that is coming and is being priced into assets.

- It is worldwide pandemic already
- China infection rates are substantially underreported

Figure 1.



- Attempts to halt the spread and shutting down economies will grow around the world trying to replicate the Chinese strategy that appears to have worked, e.g. quarantines and border closure
- Economic impact of these containment strategies will wreak havoc on local economies
- However, these efforts will likely fail and in next few months the infected in the US and in Europe will be measured in the millions not in the hundreds or thousands, so think infection rates in the 20-30% range
- While the coronavirus could ebb in warmer weather in the summer months, it could mirror the pattern of other pandemics and come back in the fall with an even greater infection/mortality rate, see Figure 1.
- Case mortality is much greater than the flu particularly if populations at risk and in EM

Figure 2.

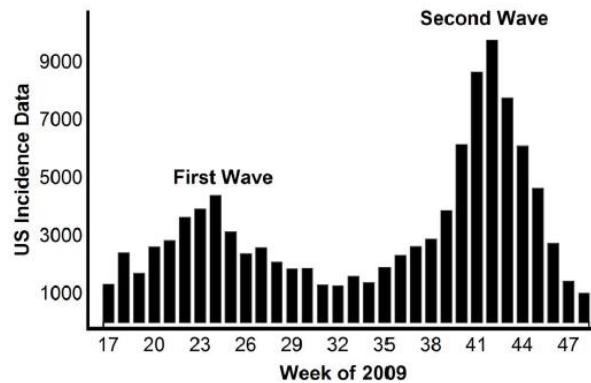


Figure 1. The H1N1 positive tests reported to the CDC in the United States from April 24, 2009 (week 17) to November 27, 2009 (week 48).

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Offsetting those negative data that fill the news cycle, the positive news should reveal:

- The China inflection rate is substantially underreported and that means mortality rates are inflated as shown in Figure 1 above, and Table 2 below.
- The data will ultimately reveal coronavirus is just a very bad flu, with high inflection rates but mortality rates substantially below what is priced in the market. As of now, this is not the Spanish flu, SARs, or MERS.

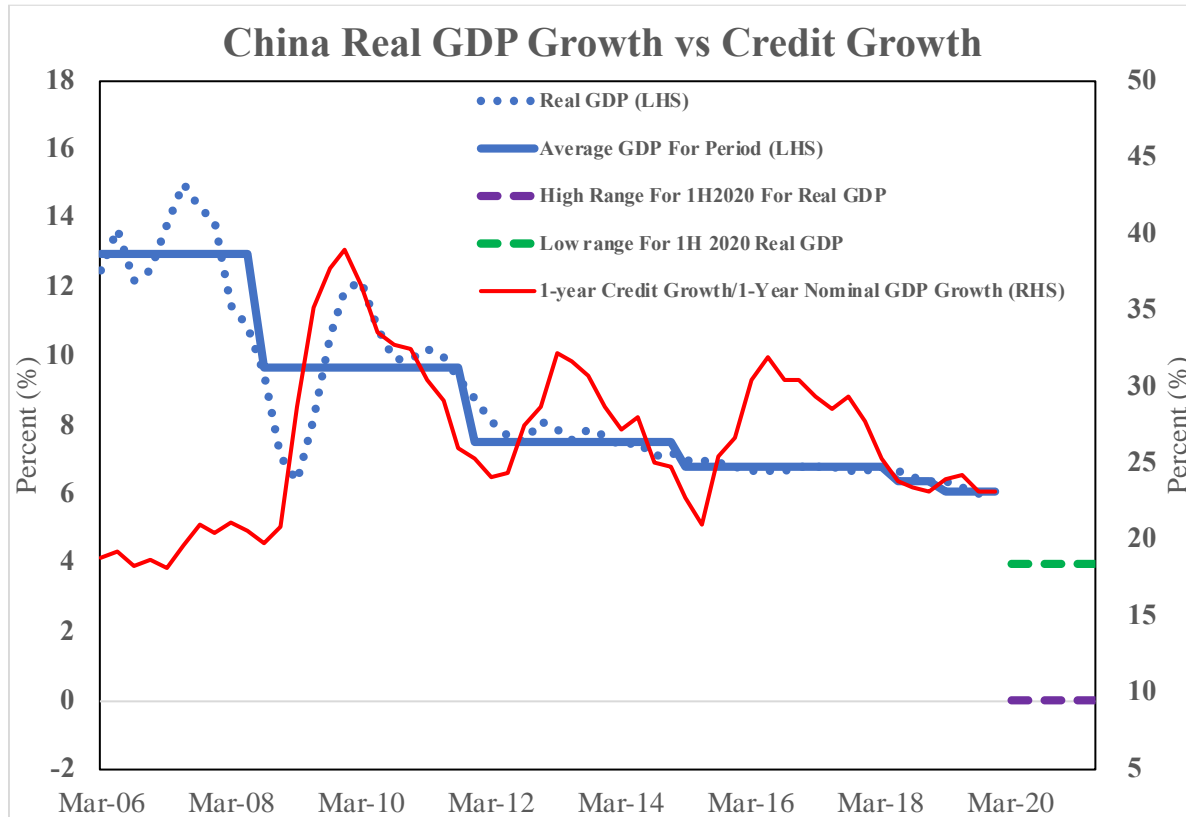
Table 2.

	Typical World Wide Seasonal Flu	Spanish Flu Level of Pandemic in World	Hubei (Wuhan)	
			Official Reporting	Model Estimates Without Containment
Number of Deaths	600,000	136,000,000	3,000	3,000
Number of Inflected	1,500,000,000	2,800,000,000	68,000	2,000,000
Mortality Rate	0.04%	4.86%	4.41%	0.15%
Mortality Rate Vs Seasonal Flu	1.0	121.4	110.3	3.8

- While the coronavirus will likely ebb in the spring, the second peak in the fall of a typical pandemic could be blunted with new antiviral meds and a potential a vaccine.

The really good news is that stimulus is coming as policy makers are responding to the worse case that could be over in a few months. This could give risk-on the type to tail wind we say 2009. Just think—What do you believe the Chinese will be doing? Look at Figure 3.

Figure 3.



Random thoughts

Oil

Another trade I am looking at is to buy Nat gas. I think the surge in oil supply by the Saudis is part of their long-term strategy to sell as much oil as they can before electric cars take over. The supply glut and the failure of the OPEC+ negotiations just accelerated that push. There are many casualties if this is indeed part of their long-term strategy: EM oil producers particularly Nigeria, Mexico and Brazil, and US shale. However, shutting down US shale could relieve the downward pressure on Nat gas. Also, buying maybe coal miners as downward pressure from Nat gas ebbs? Other casualties could electric cars. If gasoline is closer to \$1, than the incentive to move to electric cars even in Europe and China slows. I just need to do more work on the topic.

The World Is Too Flat

Clearly the upside from the “flattening the world” from globalization in production, trade and, most importantly travel is starting to dim. What the China/US economic war has started in terms of rethinking that dynamic, the coronavirus could create an even greater pressure to make the “world round again”. In the flattening world, the next corona type virus will travel even faster and potentially be even more lethal. For example, could there be another SARs with a case mortality rate of over 10% and an infection rate of the common flu. This risk could change business and economies around the world. Will airlines, and cruise ships ever recover? Just a thought and it is late. I will have more later.

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